



**Sam Woods**  
Deputy Governor and  
CEO of the Prudential Regulation Authority  
Prudential Regulation Authority

26 March 2020

Dear Chief Executive Officer

**Covid-19: IFRS 9, capital requirements and loan covenants**

The PRA is pursuing a range of regulatory and supervisory measures to alleviate the financial stability impact of the Coronavirus (Covid-19) and maintain the safety and soundness of authorised firms. These measures are aimed at ensuring that banks are able to continue to lend to households and businesses, support the real economy, and provide robust and consistent market disclosures. This letter sets out our guidance in three areas: (i) consistent and robust IFRS 9 accounting and the regulatory definition of default; (ii) the treatment of borrowers who breach covenants due to Covid-19; and (iii) the regulatory capital treatment of IFRS 9.

It is important to recognise that, while the reduction in activity associated with Covid-19 could be sharp and large, it is likely to rebound sharply when social distancing measures are lifted. In addition, in the intervening period, while activity is disrupted, substantial and substantive government and central bank measures have been put in place in the UK and internationally to support businesses and households. These measures, which have been evolving rapidly and could evolve further, are expected to remain in place through the period of disruption.

All aspects of this letter will need the urgent attention of firms. In particular, messages on accounting will be relevant to firms finalising March/April year-end annual financial statements and Q1 quarterly reports based on IFRS, as directors will need to take decisions about forward-looking expected credit loss (ECL) estimates in the coming days and weeks.

*Consistent and robust IFRS 9 accounting and the regulatory definition of default*

Any changes made to ECL to estimate the overall impact of Covid-19 will be subject to very high levels of uncertainty as so little reasonable and supportable forward-looking information is currently available on which to base those changes. This makes it even more important that ECL is implemented well and on the basis of the most robust reasonable and supportable assumptions possible in the current environment. In addition to enhancing consistency, such an implementation ought to reduce the risk of firms recognising inappropriate levels of ECL, which is very important bearing in mind that a significant overstatement of ECL could prompt behaviour that leads to unnecessary tightening in credit conditions.

To mitigate that risk, we consider it critical that firms:

- make well-balanced and consistent decisions that consider not just the potential impact of the virus, but also take full account of the unprecedented level of support provided by governments and central banks domestically and internationally to protect the economy. The need for well-balanced decisions also means that due weight will need to be given to established long-term economic trends, given the challenges of preparing detailed forecasts far into the future.
- consider the actions that will be and have already been taken to support borrowers, including the offer of payment holidays. Our expectation is that eligibility for, and use of, the UK Government's policy on the extension of payment holidays should not automatically, other things being equal, result in the loans involved being moved into Stage 2 or Stage 3 for the purposes of calculating ECL or trigger a default under the EU Capital Requirements Regulation (CRR). This expectation extends to similar schemes to respond to the adverse economic impact of the virus.

While it is for each firm to form its own view on the appropriate level of provisions in order to comply with IFRS 9, we have set out guidance in the annex to assist firms in making well-balanced and more consistent ECL estimates and in determining how to treat payment holidays and similar schemes for accounting and regulatory purposes. This guidance has been developed in the context of the exceptional circumstances arising out of Covid-19 and will be reviewed in light of future developments. We believe the guidance is consistent with IFRS 9.

#### *Treatment of borrowers who breach covenants due to Covid-19*

We recognise the important role loan covenants play in lenders' credit risk management. It is important, however, that such risk management takes into account fully the differences between 'normal' covenant breaches and some of the breaches that might occur because of the Covid-19 pandemic. For example, breaches might arise as a result of temporary changes in borrowers' reported earnings, suspension of business or other material adverse event clauses, modification of the audit report attached to audited financial statements, or as a result of unavoidable delays in providing lenders with unaudited or audited financial statements, covenant compliance certificates, or third-party valuations.

As explained in the joint statement issued by the Financial Reporting Council, the Financial Conduct Authority and the PRA on Thursday 26 March 2020, lenders and other users of financial statements are urged to consider carefully their responses to potential breaches of covenants arising directly from the Covid-19 pandemic and its consequences. Where those uncertainties are of a general nature or are firm-specific but unrelated to the solvency or liquidity of the borrower, we would expect lenders to consider the need to treat them differently compared to uncertainties that arise because of borrower-specific issues and in doing so consider waiving the resultant covenant breach. We would expect firms to do so in good faith and not to impose new charges or restrictions on customers following a covenant breach that are unrelated to the facts and circumstances that led to that breach.

Our expectation is that a covenant breach or waiver of a covenant relating to a modification of the audit report attached to audited financial statements because of the Covid-19 pandemic should not automatically, other things being equal, trigger a default under CRR or result in a move of the loans involved into Stage 2 or Stage 3 for the purposes of calculating ECL. This expectation extends to other covenant breaches and waivers of covenants with a direct link to the Covid-19 pandemic.

#### *Regulatory capital treatment of IFRS 9*

We remind you that transitional arrangements in CRR mean the regulatory capital impact of ECL is being phased in over time and during 2020, firms can add back CET1 equivalent to up to 70% of 'new' provisions due to IFRS 9. In September 2017, I wrote to firms to encourage them to make use of these arrangements<sup>1</sup>. I said then that, subject to the need for sufficient resilience at the end of the transitional period, our intention is that all aspects of supervision of a firm using the transitional arrangements would be carried out using 'transitional' data on capital resources and not 'fully loaded' figures. That remains our position.

#### *Next steps*

We ask that you consider the guidance in the annex when taking decisions about ECL and regulatory capital estimates in the coming days, weeks and months, and ensure you discuss your thinking with your supervisor as it evolves.

We are thinking about what further steps could be taken to enhance the robustness of, and bring greater consistency in, the application of IFRS 9. This might include considering aspects of the key judgements around economic scenarios; determining whether a significant increase in credit risk has occurred; the current suspension of repossessions, and treatment of guarantees. The payment holiday issue discussed above and in the annex illustrates a key issue that needs to be kept in mind in applying IFRS 9 at the moment: some of the assumptions that we have all been making no longer hold so it is important that we tread carefully and think through things afresh and in detail, in the context of the current unprecedented situation. That will take time. We intend to discuss these issues further with both firms and auditors.

We recognise the need for regulatory measures to respond to Covid-19 to be well coordinated. The PRA has been discussing and sharing information with other regulators both domestically and internationally, including coordination of policy and supervisory responses through the Basel Committee. We will continue to actively engage in these discussions.

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<sup>1</sup> <https://www.bankofengland.co.uk/prudential-regulation/letter/2017/letter-from-sam-woods-on-transitional-arrangements-for-capital-impact-of-ifrs9>

If you have any questions concerning this letter, please get in touch with me by email and copy your usual supervisory contact.

We will be publishing this letter on the Bank of England website.

Yours sincerely

A handwritten signature in black ink, appearing to read 'S. Woods', with a stylized flourish at the end.

Sam Woods

**Deputy Governor and CEO, Prudential Regulation Authority**

## **Annex: Guidance on estimating expected credit loss (ECL) and the regulatory definition of default**

1. As I explained in my letters of 25 November 2016 and 7 August 2017 on IFRS 9<sup>2</sup>, although it is not our role to set, interpret or enforce accounting standards, we have an interest in how the standards are implemented where the application of those accounting standards has an impact on our statutory objectives (for example on our assessment of ‘fit and proper’, our regulatory capital regime or on financial stability). Under the Capital Requirements Directive, the PRA can consider whether firms’ provisioning under applicable accounting standards is flowing through into its regulatory capital position in an appropriate way. We regard the effective implementation of ECL accounting to be important in ensuring the safety and soundness of PRA-authorized firms so we work with firms to share concerns, facilitate cross-industry solutions and promote high quality implementation. Our interest in ECL has been further emphasised in Vicky Saporta’s subsequent Dear CFO letters on IFRS 9, dated 18 April and 2 September 2019<sup>3</sup>.
2. The uncertainties caused by the Covid-19 pandemic and the response to it are raising a number of important ECL implementation issues. This annex discusses two issues that are particularly relevant to March period-end reporting (we will continue to explore some of the other issues) and also discusses related regulatory capital treatment for definition of default. Our objective in discussing these issues is to encourage the response to them to be robust, consistent from firm-to-firm and based on reasonable and supportable forward-looking information. If that can be achieved, the risk of significant under- or overstatement of ECL provisions ought to be reduced. Greater consistency should have the benefit of enhancing confidence in firms’ stated capital positions.

### **IFRS 9 and forward-looking information**

3. IFRS 9 requires that the forward-looking information used in ECL estimates is both reasonable and supportable. Given the sudden onset of the virus, we consider that there is very little such information available currently. Clearly markets have been trending significantly downwards and the steps being taken to contain the virus (including social distancing and business closures) could, if judged in isolation, have negative implications for borrowers’ ability to pay. Those factors should, however, not be judged in isolation because governments and central banks globally have announced unprecedented interventions to minimise the impact on individuals and corporates. In our view, preparing a detailed forecast that factors all this in fully is very challenging currently.

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<sup>2</sup> <https://www.bankofengland.co.uk/-/media/boe/files/prudential-regulation/letter/2016/letter-implementation-of-ifs9-financial-instruments>  
<https://www.bankofengland.co.uk/prudential-regulation/letter/2017/letter-from-sam-woods-ifs-9-financial-instruments>

<sup>3</sup> <https://www.bankofengland.co.uk/-/media/boe/files/prudential-regulation/letter/2019/written-auditor-reporting-update-and-main-thematic-findings>  
<https://www.bankofengland.co.uk/-/media/boe/files/prudential-regulation/letter/2019/written-auditor-reporting-thematic-feedback-from-the-2018-19-reporting-period.pdf>

4. We believe the immediate implications of that for financial reporting are:

- Economic scenarios and probability-weights: In addition to the challenges already mentioned, the situation is evolving rapidly and changes to consensus data are likely to lag government and central bank interventions. This seems likely to mean that, if any substantive changes are to be made to the ECL estimates at March period-end, those changes will be driven predominantly by adjustments ('overlays'). It is essential that overlays are the subject of high-quality governance, given the unprecedented nature of the current situation and the significant uncertainties that exist.
- Model adjustments: In exceptional credit conditions, traditional drivers of credit risk, when considered in isolation, tend not provide a complete picture of how credit risk and losses are evolving. For example, given unprecedented levels of government-led support for borrowers, normal relationships between credit risk and economic variables may not prove a reliable guide. Events like a temporary loss of income will not necessarily have the same consequences as in the past. There has not been enough time and there is not enough information for these factors to have fed through to lenders' models. This also means greater reliance being placed on overlays and the governance around them.

5. Bearing this in mind, we have included some observations below that we suggest need to be taken into account in the governance process around economic scenarios, probability weights, model adjustments and overlays. Whilst it is for each firm to form its own view as to appropriate provision levels in order to comply with IFRS 9, we consider that to make well-balanced judgements about ECL it is essential to:

- recognise that, although it is difficult to forecast the impact of the pandemic itself and although the amount of forward-looking information on the subject is very limited, there are clear signs that, taken in isolation, economic and credit conditions are worsening. It is, however, equally important also to take into account the significant economic support measures announced by domestic and international fiscal and monetary authorities and the measures – such as payment holidays and new lending facilities – that are being made available to assist borrowers affected by the Covid-19 outbreak to resume regular payments.
- reflect that the economic shock from the pandemic should be temporary, although its duration is uncertain. While it is plausible to assume that the economic consequences of the pandemic could mean that some borrowers will suffer a long-term deterioration in credit risk, many will need the support measures in the short-term but will not suffer a deterioration in their lifetime probability of default.
- give due weight to established long-term economic trends when preparing long-term forecasts, given the challenges of preparing detailed forecasts far into the future. The temporary nature of the pandemic means that firms will need to consider the appropriateness both of their existing forecast period and of the way in which and speed at which conditions

then return to the longer-term trend. Compared to the practices we can see pre-pandemic, it seems likely that this will involve in many cases a shortening of the forecast period and a much quicker return to the long-term historical trend. This is relevant to forecasts used to estimate both probability of default and loss given default, and for both individual (ie case-by-case) and modelled approaches.

- avoid double-counting between any adjustments for Covid-19 and existing adjustments for other uncertainties such as EU withdrawal.
6. We are thinking about what further steps could be taken to enhance the robustness of, and bring greater consistency in, the application of the requirements of IFRS 9 to consider economic scenarios. We intend to discuss this as part of our continuing work with firms on consistent application of ECL.

### **Treatment of payment holidays and similar schemes**

7. Our expectation is that eligibility for, and use of, the UK Government's policy on the extension of payment holidays should not automatically, other things being equal, trigger:
- a default under CRR; and
  - the loans involved being moved into Stage 2 or Stage 3 for the purposes of calculating ECL.
8. The above expectation extends to similar government-endorsed schemes, and similar measures by firms, to respond to the adverse economic impact of the virus, including those for small and medium-sized enterprises.

### *Regulatory definition of default*

9. We do not consider the use of a Covid-19 related payment holiday by a borrower to trigger the counting of days past due or generate arrears under CRR<sup>4</sup>. We also do not consider the use of such a payment holiday to result automatically in the borrower being considered unlikely to pay under CRR.
10. Firms are reminded to apply sound risk management practices regarding the identification of defaults. Firms should continue to assess borrowers for other indicators of unlikeliness to pay, taking into consideration the underlying cause of any financial difficulty and whether it is likely to be temporary as a result of Covid-19 or longer term.

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<sup>4</sup> The PRA statement of 20 March 2020 sets out the delay in the PRA's implementation of proposals related to the Internal Ratings Based approach, including on the Definition of Default, until 1 January 2022. <https://www.bankofengland.co.uk/news/2020/march/boe-announces-supervisory-and-prudential-policy-measures-to-address-the-challenges-of-covid-19>

*Identifying whether a significant increase in credit risk (SICR) has occurred for IFRS 9*

11. Under IFRS 9, loans are required to be moved from Stage 1 to Stage 2 if and only if they have been the subject of a SICR. A SICR occurs when there has been a significant increase in the risk of a default occurring over the expected life of a financial instrument.
12. To date payment holidays granted in response to financial difficulty have generally been regarded as a reliable proxy for identifying whether a SICR has occurred. We consider that in the case of government-endorsed payment holidays (and similar schemes), the position is different and it should not be assumed that those borrowers that are granted a payment holiday have suffered a SICR. Our reasoning is set out in the next few paragraphs.
13. In line with Basel guidance on ECL<sup>5</sup>, we expect that the definition of default and the convention for counting days past due adopted for accounting purposes will be guided by the definition used for regulatory purposes. Therefore we consider that use of government-endorsed payment holidays by a borrower would not on its own trigger the counting of days past due for the 30 days past due backstop used to determine SICR or the 90 days past due backstop used to determine default.
14. Furthermore, assuming a SICR has occurred for all the borrowers that benefit from a payment holiday as a result of Covid-19 is likely to be a poor reflection of the reality of the situation. The eligibility criteria is broad and borrowers need not have experienced a SICR for them to access them. In addition, use of payment holidays may indicate short-term liquidity or cash flow problems but is likely to provide little information to enable banks to differentiate borrowers' lifetime credit risk. Under normal circumstances, lenders would be expected to gather information about the financial circumstances of the borrower before providing a payment holiday and would tailor the terms of the payment holiday to those circumstances. Our understanding is that in the short-term the circumstances surrounding a request for a payment holiday will not be investigated sufficiently for the lender to obtain sufficient information to be able to use the granting of the payment holiday as a sole indicator that SICR has occurred or even as the basis to adjust the borrower's probability of default.
15. The treatment above is consistent with payment holidays being granted as part of an unprecedented government-led effort to support the economy amid the Covid-19 outbreak, rather than being granted in response to the circumstances of individual borrowers. The treatment above is also consistent with relevant FCA guidance for firms<sup>6</sup>, which refers to granting mortgage payment holidays 'where a customer indicates they may potentially experience payment difficulties in the current circumstances', and notes 'there is no expectation under this guidance that the firm investigates the circumstances surrounding a request for a payment holiday', and

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<sup>5</sup> <https://www.bis.org/bcbs/publ/d350.pdf>

<sup>6</sup> <https://www.fca.org.uk/firms/mortgages-coronavirus-guidance-firms>



'there should be no negative impact on the customer's credit score because of the payment holiday'.

16. For some banks, the treatment described above will flow from their existing accounting policies. For those banks, the option to take a payment holiday is a standard feature of many loan contracts that allows borrowers flexibility to manage their liquidity, so when such options are exercised at a customer's discretion it is not used as an SICR trigger. Customers now have additional rights to payment holidays to manage liquidity, regardless of whether this was a feature of their original contract.
17. Nevertheless, government-endorsed payment holidays are also available to be used in response to some sort of financial difficulty – which may indicate some increase in credit risk for some borrowers. The question is whether that increase in credit risk is significant when judged over the expected life of the loan. We understand that some lenders intend to try to differentiate between borrowers who request a payment holiday to manage liquidity due to short-term cash-flow disruption that are expected to return to regular payments (they would remain in Stage 1), and borrowers expected to be more permanently impacted (they would move to Stage 2). This is right in principle but likely to be operationally complex.
18. To assist firms in making these judgements we observe that:
  - some high-level but balanced method would need to be found to allocate a proportion of the loans on which payment holidays have been granted to Stage 2 so as to comply with the principles underpinning IFRS 9. Due to the absence of detailed information, it is unlikely to be appropriate simply to assume a SICR event unless there is evidence to the contrary.
  - provided lenders' other SICR criteria operate effectively, a method that we consider to be credible is to assess whether the overall impact on ECL could be material by considering the differential between 12 month and lifetime ECL for the volume of customers that have received a payment holiday but show no other indicators of SICR. If deemed material, an overarching allocation could be made based on a sample of accounts.
19. The accounting analysis above focuses specifically on government-endorsed payment holidays but is expected to be broadly relevant for similar measures by firms to respond to the adverse economic impact of the virus.
20. To achieve consistency in the longer term it may be necessary for lenders to establish new SICR policies and processes for monitoring, and the accounting treatment of, programmes to respond to the adverse economic impact of the virus. We intend to discuss this as part of our continuing work with firms on consistent application of ECL.

### **Treatment of borrowers who breach covenants due to Covid-19**

21. Our expectation is that that a covenant breach or waiver of a covenant relating to a modification of the audit report attached to audited financial statements because of the Covid-19 pandemic should not automatically, other things being equal, trigger:

- a default under CRR; and
- the loans involved being moved into Stage 2 or Stage 3 for the purposes of calculating ECL.

22. The above expectation extends to other covenant breaches and waivers of covenants with a direct link to the Covid-19 pandemic. We consider that it is important that firms' assessment of covenant breaches takes into account fully the differences between 'normal' covenant breaches and some of the breaches that might occur because of the Covid-19 pandemic.

#### *Regulatory definition of default*

23. A breach of the covenants of a credit contract is a possible indication of unlikelihood to pay under the CRR definition of default. However, a covenant breach does not automatically trigger a default. Rather, firms have scope to assess covenant breaches on a case-by-case basis and determine whether they indicate unlikelihood to pay.

#### *Identifying whether a significant increase in credit risk (SICR) has occurred for IFRS 9*

24. To date a counterparty's financial statements being subject to delay, a modified audit opinion or material uncertainties about going concern would typically be the result of a change in the borrowers' operating results or ability to meet its debt obligations as they fall due, and would therefore indicate an increase in credit risk. For that reason, they would generally have been regarded as a reliable proxy for identifying whether a SICR or default has occurred.

25. We consider that in the short-term such delays, modifications and material uncertainties will be much more frequent and may be due to factors that are not sufficiently closely related to the borrowers' credit risk to be used as a reliable proxy for identifying SICR. For example, an auditor might need to modify an audit opinion because they have been unable to gather the necessary audit evidence to complete the audit in full. This may be because of an inability to do onsite work or access geographical locations subject to a lockdown, or because the level of uncertainty has meant the auditor has not been able to conclude its going concern assessment.

26. In our view, the underlying reason for delays, modified audit opinions or material uncertainties about going concern in the context of the current environment will need to be assessed on a case-by-case basis. Subject to that individual assessment, we would expect that when the reasons are of a general nature or are firm-specific but unrelated to the solvency or the liquidity of the borrower, the conclusion will generally be that neither a SICR nor default has occurred.

27. The accounting analysis above focuses specifically on a modification of the audit report but is expected to be broadly relevant for other covenant breaches with a direct link to the Covid-19 pandemic.